Economic Outlook

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The U.S. economic expansion is approaching its sixth birthday with a full head of steam. The Commerce Department reported second-quarter GNP growth at a 3.1% annual rate in its advance estimate. Even more striking was an upward revision to 1987 growth, which now stands at a very strong 5% pace, compared with the 4% rate originally reported. The bad news is that inflation picked up sharply in the second quarter with the GNP price index rising 4.7%, compared with 3.5% in the first. Labor cost measures recently released also show an accelerating tendency (see chart), which is not too surprising given the developing imbalances between labor supply and demand. The Federal Reserve is trying to douse the spreading sparks of inflation with higher interest rates. But rising incomes, profits and confidence are adding more oxygen as the inflationary embers glow with a growing intensity.

Moderate second-quarter GNP growth masked another quarter of 5%-plus growth in real final sales. Strength in final demand was across the board, including another round of large contributions by consumers, businesses, and foreigners. The Commerce Department reported that drought-related problems in the agricultural sector reduced second-quarter output by about a half percent. Another area of weak growth was the government sector, which has made little contribution to economic growth so far this year.

The employment report for July was quite strong, showing good growth across a wide spectrum of industries. Payroll employment grew by 285,000, following an upward revised increase of 532,000 jobs in June. Over the past year almost 4 million jobs have been created according to the payroll survey, compared with about 2.5 million in the household survey. Part of the discrepancy arises because a person with two jobs is counted twice in the payroll survey, but only once in the household survey. This increase in multiple job holding suggests further economic growth will be hampered by labor shortages and wage inflation. Another effect of scraping the bottom of the labor barrel is falling productivity. Nonfarm labor productivity plunged 1.7% in the second quarter, as unit labor costs soared at a 5.9% annual rate.

The Federal Reserve's Tan Book Survey of regional economic conditions for the August 16 FOMC meeting reports continued economic expansion at a moderate to strong pace in all but two of the 12 districts. The survey notes tight labor market conditions in some areas. It also finds that "capacity constraints and shortages have developed in some districts and materials price increases are

widespread." The survey does identify some pockets of weakness, including certain building materials industries, military expenditures, agriculture, apparel sales, and excess inventories of imported motor vehicles. A good bit of apparel is imported, and consumers have balked at sharp price increases stemming from the dollar's decline. Imports of cars and especially trucks have also met with price resistance, causing a rise in domestic producers' share of the overall vehicle market this year. The weakness in building materials is mixed. Overall construction spending is still growing with a surge in non-residential construction more than offsetting a drop in residential construction. Industrial construction is up 20% over the past year as businesses expand capacity. The purchasing managers' report on July business conditions confirms the Tan Book view that the economy is continuing to grow at a good pace in the third quarter.

The latest indicators paint a picture of an economy growing at better than a 3.5% rate, which is too fast for an expansion this old. Price increases will spread as capacity is strained in more and more sectors. Wage increases are likely to continue their upward trend. Fortunately, strong capital spending is adding new capacity and foreign competition will help restrain price increases, while higher interest rates will help restrain domestic demand. But the expansion will still be breathing quite a bit harder next year at its seventh birthday party.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
	1987		1988		1988		1989		1986-	1987-	1988-
	III	IV	I	II	III	IV	I	II	1987	1988	1989
Consumer Spending	3.0	-1.4	2.9	1.5	1.3	1.2	1.1	0.8	1.8	1.5	1.0
Business Investment	3.0	0.2	0.9	1.6	1.3	1.2	1.1	1.0	0.3	1.3	1.1
Residential Investment	-0.6	0.0	-0.3	0.1	-0.1	-0.2	-0.2	-0.2	0.0	-0.1	-0.2
Change in Inventories*	-1.0	6.3	-2.0	-1.9	0.2	0.2	0.1	0.2	0.2	0.1	0.1
Net Exports	-0.5	0.5	1.7	1.9	0.7	0.6	0.6	0.6	0.2	1.0	0.7
Government Purchase*	0.6	0.5	0.2	-0.1	0.3	0.3	0.3	0.3	0.9	0.3	0.3
Real GNP	4.5	6.1	3.4	3.1	3.7	3.3	3.0	2.7	3.4	4.1	3.0

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
	1987		1988		1988		1989		1986-	1987-	1988-
	III	IV	I	II	III	IV	I	II	1987	1988	1989
Nominal GNP	7.7	8.6	5.4	7.2	8.6	8.5	8.6	8.8	6.8	7.4	8.6
GNP Deflator	3.1	2.4	1.7	4.1	4.6	5.0	5.4	5.9	3.3	3.1	5.4
Corporate Profits After Tax#	12.7	5.7	10.3	9.3F	8.4	7.8	7.4	6.3	10.2	8.9	6.4

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	May	June	July	1987	1988	1989
Consumer Price Index** (%)	0.3	0.3	n.a.	4.4	4.8	6.3
Industrial Production (%)	0.5	0.4	n.a.	3.7	5.2	3.0
Retail Sales (%)	0.3	0.5	n.a.	5.1	5.4	5.2
Auto Sales (million units, a.r.)	10.4	11.0	10.7	10.3	10.3	9.3
Housing Starts (million units, a.r.)	1.38	1.45	n.a.	1.63	1.45	1.35
Unemployment Rate (%)	5.6	5.3	5.4	6.2	5.4	5.2
Merchandise Trade Balance ($ bn., a.r.)	-131.2	n.a.	n.a.	-171.2	-145.0	-110.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. August 10, 1988
#Quarterly data are year-over-year percent changes.
a.r. = annual rate F = forecast